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In the Supreme Court of the United States

OCTOBER TERM, 1959

No. 108

MILL RIDGE COAL COMPANY, PETITIONER

v.

GEORGE D. PATTERSON, DISTRICT DIRECTOR OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINION BELOW

The opinion of the court of appeals (Pet. 1a–8a) is reported at 264 F. 2d 713.

JURISDICTION

The judgment of the court of appeals was entered on March 12, 1959 (Pet. 8a). The petition for a writ of certiorari was filed on June 10, 1959. The jurisdiction of this Court is invoked under 28 U.S.C. 1254 (1).

QUESTION PRESENTED

A corporation with accumulated operating losses disposed of all its assets and went out of business.

New owners then acquired all its stock and used the corporation to operate a new business. The question is whether the corporation may carry over and deduct against the income of the new business the losses incurred in the old business, that having been the principal purpose of its acquisition by the new owners.

STATUTES INVOLVED

Sections 23(s), 122(b), and 129(a) of the Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.) and §§ 172 (a) and (g) and 269(a) of the Internal Revenue Code of 1954 (26 U.S.C., Supp. V) are set forth in the Appendix, *infra*, pp. 11–13.

STATEMENT

From its organization in 1947 until the end of 1953, all the stock of the taxpayer corporation was owned by Charles and Prince DeBardeleben. The taxpayer operated a coal mine in Kentucky from September 1948 until March 1951 and then leased the mine to others until September 1952. It sold the mine and all its physical assets on September 1, 1952, and from then until December 31, 1953, conducted no further business. Its income tax returns showed a net operating loss for every fiscal year from August 31, 1948, to August 31, 1953. (Pet. 2a.)

On December 31, 1953, the taxpayer transferred to Charles DeBardeleben its only remaining asset, the secured note it had received on the sale of its properties. Its balance sheet then showed assets of zero and liabilities (almost entirely debenture notes held by the DeBardelebens) of about $297,000. On the same

date, the DeBardelebens sold all their stock and debenture notes to Elliott T. Williams, Jr., for $5,475.52. In February 1954, new stock certificates were issued to Williams, one William E. Tomlinson, and three other persons. (Pet. 2a.)

The circumstances of the acquisition of taxpayer's stock by the Williams-Tomlinson group were as follows: On December 3, 1953, the Tennessee Coal and Iron Division of the United States Steel Corportation (TCI) agreed to enter a contract to purchase fuel oil from Tomlinson. In November 1953, Tomlinson had formed the Bunker Oil Company to perform the anticipated contract and had sought to interest Williams in the company. After the stock of the taxpayer was acquired by the group, however, it, rather than Bunker, was used to execute the formal contract with TCI (on March 17, 1954), and Bunker was dissolved. The taxpayer began selling fuel oil to TCI on August 31, 1954, and at no time after the purchase of its stock by the group did it engage in the coal business. Williams testified that the principal reason for buying the corporation was to get the tax benefit of its earlier losses, and Tomlinson likewise testified that that was one of the major reasons for his buying stock in the taxpayer. (Pet. 2a–3a; R. 77–78, 86, 91–92.)

On its income tax return for the fiscal year ending August 31, 1955, the taxpayer deducted, as a net operating loss carryover, the losses it had incurred in the coal business while its shares had been owned by the DeBardelebens. The Commissioner disallowed the

deduction, and the taxpayer, having paid the resulting deficiency, brought this suit for refund. (Pet. 2a–3a.) The district court directed a verdict for the respondent (R. 89–95), and the court of appeals affirmed (Pet. 1a–8a).

ARGUMENT

On December 31, 1953, the taxpayer was a defunct corporation. It had no assets, no business, and no prospects. It did, however, have accumulated operating losses which offered the prospect of carryover deductions against future income. New interests then acquired the taxpayer's corporate shell through which to carry on a new business, hoping thereby to utilize the taxpayer's past losses as deductions against the income from the new business. Since taxpayer had nothing else, its purchase was neither more nor less than an attempted purchase of a net operating loss carryover. The courts below held that the Code did not contemplate such a use of operating loss carryovers. That decision, we submit, is clearly correct, and there is no conflict of decisions or other reason for review by this Court.

1. *a.* Although involving a different factual situation, this case is controlled by the rationale of this Court's decision in *Libson Shops, Inc.* v. *Kohler*, 353 U.S. 382. In that case, 17 commonly-owned corporations (separate retail stores and a management company) were merged into one, and the surviving corporation sought to deduct from its subsequent income losses carried over from three of the merged corporations, the businesses of which continued to be

operated at a loss. The controlling provision, § 122(b)(2)(C) of the 1939 Code, provided:

> If for any taxable year * * *, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the three succeeding taxable years * * *.

Although the issue was framed as being whether the surviving corporation was "the taxpayer" which had incurred the losses, the Court expressly declined to make the result turn on whether a corporation resulting from a statutory merger is to be treated as the "same taxable entity" as its predecessors (pp. 385–386). It rested its decision instead on the broader ground that the underlying purposes of the carryover provisions—to ameliorate the hardship of an annual accounting system when a business' income fluctuates from year to year—precluded their application where there is not a "continuity of business enterprise" (p. 368).

In *Libson Shops*, the only lack of continuity (since the same interests owned the corporations both before and after the merger and the businesses, although consolidated, remain unchanged) was that the pre-merger losses of three of the stores were being used to offset the post-merger income of the *other* stores. Here, however, there is a total lack of continuity of any kind, there having been a complete change both of ownership and of business. Admittedly the two enterprises were conducted under the same corporate charter and thus through the same legal "entity", but the *Libson Shops* opinion expressly rejects such formalistic

tests and looks instead to the substance of the relationship between the enterprise incurring the loss and that seeking to deduct it. Looking to the substance here, there was simply an attempt by one enterprise to purchase the accumulated losses of another. Such a use of a carryover deduction—in effect, making a defunct business' loss carryover an independently marketable commodity—is clearly not within the purpose of the carryover provisions.

b. Petitioner contends that this case is governed by § 172 of the 1954 Code rather than the predecessor provision of the 1939 Code (§ 122) construed in *Libson Shops.* Even so, the result is the same. While the reference to "the taxpayer" in § 122 of the 1939 Codes does not appear in § 172 of the 1954 Code, that difference is due only to the change in the form of the carryover provisions in the 1954 Code, and there is nothing to indicate that any difference of substance was intended. In any event, *Libson Shops* turned not, as petitioner contends, on the meaning attributed to the words "the taxpayer," but on the purposes attributed to the carryover provisions as a whole. Those purposes have not been changed by the 1954 Code, and the reasons for reading into § 122 of the 1939 Code a "continuity of business enterprise" requirement are equally applicable to § 172 of the 1954 Code.[1]

[1] While for the above reasons we think the question immaterial, it is our view that the issue in this case is in fact governed by § 122 of the 1939 Code rather than by § 172 of the 1954 Code. Although the taxable year involved is governed generally by the 1954 Code, § 172(g)(1) provides that "the determination of the taxable years * * * to which a net operating

c. Turning to provisions of the 1954 Code other than the basic carryover provisions of § 172, petitioner contends that the judicially-evolved continuity test has been displaced by special provisions defining in detail the circumstances under which carryovers will be disallowed. Those provisions are § 381, which prescribes the extent to which operating loss carryovers survive a reorganization (the *Libson Shops* situation), and § 382, which provides that a single continuing corporation may lose the right to carry over losses upon a substantial change of ownership (essentially, a 50% change) and a simultaneous change of business (the situation here). If those provisions qualify the limitations otherwise implicit in § 172 and recognized in *Libson Shops*,[2] they can do so only in cases to which they apply. And if § 382 did apply here, it would itself disallow the carryover deduction. In fact,

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loss for any [pre-1954 Code] taxable year * * * may be carried shall be made under the" 1939 Code. Possibly that provision could be read as making the 1939 Code controlling only on the number of years over which a loss can be carried forward, but other provisions of the 1954 Code would seem to require a construction making the 1939 Code controlling also on the question here. The provisions of the 1954 Code dealing with the effect of similar transactions on the right to carry over losses (§§ 381–382, see pp. 7–8, *infra*) were expressly made applicable only to transactions *occurring* after the effective date of the 1954 Code (see § 394 (a) and (b)), and the only reasonable inference is that the effect of prior transactions was to continue to be governed by the prior law—*i.e.*, the 1939 Code.

[2] In the *Libson Shops* situation itself, the Internal Revenue Service has recognized that § 381 is controlling in any case to which § 381(a) applies. T.I.R. No. 89, August 25, 1958; P-H 1958 Fed. Tax Rep. ¶ 55,060.

of course, that section applies only to cases in which the change of ownership occurred after June 22, 1954 (see § 394(b)), so that the effect of changes of ownership and business prior to that time, as in this case, continues to be governed by the implicit limitations of § 172 itself—limitations which, as explicated in *Libson Shops,* equally preclude the deduction here. There is not—as the taxpayer in effect contends—a hiatus during which the express disallowance of such deductions by § 382 is inapplicable but yet is effective to supersede the limitations implicit in § 172. One or the other controls, and on the facts here the deduction would be forbidden by both.

2. As an alternative ground for decision, the court of appeals held that the carryover deduction was also properly disallowed under § 129(a) of the 1939 Code and its successor, § 269(a) of the 1954 Code. In relevant part, those sections identically provide that:

> If * * * any person or persons acquire * * * control of a corporation, * * * and the principal purpose for which such acquisition was made is evasion or avoidance of * * * tax by securing the benefit of a deduction, credit, or other allowance which such person * * * would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. * * *.

Admittedly, the principal purpose of the acquisition here was to utilize the taxpayer's accumulated losses in the coal business as deductions against the profits the new owners anticipated making in the fuel oil business. The only question is whether the fact that the carryover deduction is taken by the acquired

corporation itself, with the acquiring "persons" securing the "benefit" only indirectly, precludes the application of the section. In our view, it clearly does not. In terms, the purpose of the acquiring persons need not be to secure a "deduction" themselves; it need only be a purpose to avoid taxes by "securing the benefit of" a deduction. While the deduction itself can be taken only by the corporation, it is the new owners who will ultimately secure the benefit of the deduction and it was to obtain that benefit that they acquired the corporation. That interpretation has been adopted by the Fourth Circuit (*Coastal Oil Storage Co.* v. *Commissioner,* 242 F. 2d 396) as well as by the court below, and a contrary interpretation of the section as not applying to cases of this sort—perhaps the clearest example of a tax-avoidance dealing in corporate charters—would, we submit, frustrate its very purposes.

3. There is no conflict of decisions among the courts of appeals and, while the Tax Court has adopted a contrary view on both grounds of the decision below, its latest decision on those issues is now pending on review before the Court of Appeals for the Ninth Circuit. *British Motor Car Distributors, Ltd.* v. *Commissioner,* 31 T.C. 437. Since the 1954 Code expressly prescribes the extent to which the right to carry over losses survives changes in ownership and business occurring after June 22, 1954, the question posed by this case is of continually diminishing importance, and in the absence of a conflict of decisions there is no need for review of the question by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JULY 1959.

APPENDIX

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

SEC. 23. * * * In computing net income there shall be allowed as deductions:

* * * * * *

(s) * * * For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

* * * * * *

SEC. 122[(b)(2)(B)]. * * * If for any taxable year beginning after December 31, 1949, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the five succeeding taxable years, except the carry-over in the case of each such succeeding taxable year (other than the first succeeding taxable year) shall be the excess, if any, of the amount of such net operating loss over the sum of the net income for each of the intervening years computed—

* * * * * *

SEC. 129. * * * (a) * * * If (1) any person or persons acquire, on or after October 8, 1940, directly or indirectly, control of a corporation, or (2) any corporation acquires, on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately prior to such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal

purpose for which such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For the purposes of clauses (1) and (2), control means the ownership of stock possessing at least 50 per centum of the total combined voting power of all classes of stock entitled to vote or at least 50 per centum of the total value of shares of all classes of stock of the corporation.

* * * * *

Internal Revenue Code of 1954 (26 U.S.C., Supp. V):

SEC. 172. NET OPERATING LOSS DEDUCTION.

(a) *Deduction Allowed.*—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

* * * * *

(g) *Special Transitional Rules.*—

(1) *Losses for taxable years ending before January 1, 1954.*—For purposes of this section, the determination of the taxable years ending after December 31, 1953, to which a net operating loss for any taxable year ending before January 1, 1954, may be carried shall be made under the Internal Revenue Code of 1939.

* * * * *

SEC. 269. ACQUISITIONS MADE TO EVADE OR AVOID INCOME TAX.

(a) *In General.*—
If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

* * * * *

U. S. GOVERNMENT PRINTING OFFICE: 1939